Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:CIN:2:TL-N-6203-00
GRShuler

date:

to: Sidney Saewitz, Team Manager, LM:RFP:1521:GP
Cincinnati, Ohio

from: Associate Area Counsel (LMSB), Cincinnati

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subject: [redacted]
EIN: [redacted]
Advisory Opinion on Bad Debt

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By a memorandum dated October 24, 2000 that was supplemented by additional information on December 11, 2000, you requested assistance on several issues relating to [redacted].

ISSUES

1. Who were the members of the [redacted]?

2. Were the transfers of funds from [redacted] to [redacted], with whom it had no business relationship other than common shareholders, contributions to capital rather than business loans?

3. Did the common shareholders of [redacted] and [redacted] receive constructive dividends from [redacted] as a result of the transfers of funds?

CONCLUSIONS

1. The members of the [redacted] are those individuals that signed the Operating Agreement.

2. Yes. Based on the facts provided, the transfers of funds from [redacted] to [redacted] were contributions to capital.

3. Yes. Based on the facts provided, the common shareholders of [redacted] and [redacted] received constructive dividends from [redacted] as a result of the transfers of funds.

FACTS

The facts as we understand them follow: In [redacted], [redacted], began operating the [redacted] as a sole proprietorship. The [redacted] was incorporated on [redacted]. In the [redacted]'s and [redacted]'s, [redacted]'s family joined the business. [redacted]'s [redacted], [redacted], [redacted], and [redacted], became involved in the business and took over ownership after [redacted] in [redacted].

In [redacted], [redacted] percent of the stock of the [redacted] was transferred to the [redacted]. The income beneficiaries of the [redacted] are [redacted] ([redacted] percent), [redacted] ([redacted] percent), [redacted] ([redacted] percent), the [redacted] ([redacted] percent), the [redacted] of [redacted] ([redacted] percent), and [redacted] ([redacted] percent). The [redacted] owns [redacted] percent of the stock of [redacted]. [redacted] received [redacted] percent of the shares of the [redacted] from the [redacted] in exchange for its [redacted] share of stock.

[redacted] is a full-service company offering [redacted] products and [redacted] for the [redacted] industry, featuring [redacted], as well as [redacted]. Each year [redacted] publishes the "[redacted]" for more than [redacted] customers. The [redacted] contains more than [redacted] products. Since [redacted], [redacted] has been organized into three divisions: marketing, distribution, and finance/administration. [redacted] employs approximately [redacted] employees that include sales representatives, telemarketers, and warehouse employees.

[redacted] filed a consolidated tax return with the Internal Revenue Service for itself and its subsidiaries for the tax year ending [redacted]. The statutory period of limitations for assessment for the tax year ending [redacted] expires on [redacted]. On its [redacted] tax return, [redacted] claimed an ordinary loss from bad debt in the amount of $[redacted] from a purported loan to [redacted] which ceased operations in early [redacted].

[redacted], also known as [redacted], was organized in [redacted] on [redacted]. The Articles of Organization of the [redacted] state that the purpose for which the [redacted] was organized was:

> to engage in and do any lawful act concerning any or all lawful businesses for which limited liability companies may be organized according to the laws of the State of [redacted] including all powers and purposes now and hereafter permitted by law to a limited liability company, except banking or insurance.[1]

The Operating Agreement of the [redacted] ("Operating Agreement") indicated that the members of the [redacted] were [redacted], [redacted], [redacted], [redacted],

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[1] A limited liability company may be organized under the [redacted] act for any lawful purpose, except for the purpose of [redacted] as defined in [redacted].

[redacted], [redacted] and [redacted][2]. Each of these individuals, except [redacted], signed the Operating Agreement as a "member."[3] [redacted] of the Operating Agreement defined "member" [redacted]. Section [redacted] of the Operating Agreement provided that the [redacted] would consist of [redacted]. As specified in Exhibit [redacted] of the Operating Agreement, the units of the [redacted] were divided among the members as follows:

Member	Units
[redacted]	[redacted]

Section [redacted] of the Operating Agreement stipulated that the members of the [redacted] should contribute [redacted] in the amount of $[redacted]. Specifically, each member was to contribute the following amount as set forth in Exhibit [redacted] of the Operating Agreement[4]:

Member	Contribution
[redacted]	$[redacted]

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[2] [redacted], an attorney with the law firm of [redacted] located in [redacted], Ohio, is the current representative of [redacted].

[3] [redacted] signed on behalf of [redacted] as a "partner."

[4] The shareholders of [redacted] made cash advances to the [redacted] at the time of its formation in excess of those amounts which were required to be contributed per the Operating Agreement. On [redacted], the shareholders of [redacted] caused [redacted] to transfer the amount of $[redacted] to the [redacted].

The financial statements of the [redacted] indicate that the members' capital accounts were in the amounts of $[redacted] and $[redacted] respectively, for the tax years ending [redacted] and [redacted]. The statements do not provide a specific breakdown of each member's capital account.

For the taxable years ending [redacted] and [redacted], the [redacted] filed Forms 1065, U.S. Partnership Return of Income, with the Internal Revenue Service. The principal business activity of the [redacted] that was listed on the forms was real estate development. The [redacted] members' percentage of profit and loss sharing listed on the Schedules K-1 corresponded to the member's ownership of the [redacted] as reflected in the Operating Agreement[5]. Schedule M-2 of the initial return for the [redacted] for the taxable year [redacted] indicates that there was no capital contributed to the [redacted] during the taxable year. Similarly on the Schedules K-1, each member's capital account at the beginning and ending of the [redacted] year had [redacted] balances.

On Schedule M-2 of the Form 1065 filed by the [redacted] for the taxable year ending [redacted], the [redacted] reported a beginning balance in the amount of $[redacted] as well as capital contributions in the amount of $[redacted] during the tax year. The [redacted] Schedules K-1 for members [redacted], [redacted], [redacted], [redacted] and [redacted] indicate that those members had capital accounts at the beginning and ending of the year with [redacted] balances. The [redacted] Schedule K-1 for [redacted] indicates that he had a capital account with a balance in the amount of $[redacted] at the beginning of the year. The balance of the capital account of [redacted] was offset by losses in the amount of $[redacted] resulting in a capital account with a [redacted] balance at the end of the year. The [redacted] Schedule K-1 for [redacted] indicates that he had a capital account with a balance of [redacted] at the beginning of the year and contributed capital in the amount of $[redacted] during the year. The balance of the capital account of [redacted] was offset by losses in the amount of $[redacted] resulting in a capital account with a [redacted] balance at the end of the year.

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[5] Section [redacted] of the Operating Agreement required that each member's distributive share of all tax related items, including [redacted]

The [redacted] signed a promissory note to [redacted] in the amount of "$[redacted] or so much thereof as may be advanced and outstanding pursuant to any advances made by the Lender [[redacted]] to the Company [the [redacted] according to the grid annexed hereto." The note was dated [redacted]. Between [redacted] and [redacted], [redacted] transferred funds to the [redacted] in the amount of $[redacted] as indicated on the annexed grid attached to the promissory note.

The promissory note was a demand promissory note with a stated interest rate corresponding to the applicable Federal rate. The promissory note had no fixed maturity date and no demand was made on the note. The promissory note was not secured by any assets of the [redacted][6]. [redacted] did not require the individual members of the [redacted] to personally guaranty the promissory note and no guaranty was given by the members of the [redacted][7] There is no evidence that [redacted] established a repayment schedule for interest and principal and no such repayment was made by the [redacted] For the [redacted] financial statement of [redacted], an adjusting journal entry of accrued but unpaid interest in the amount of $[redacted] was made. [redacted] did not record this journal entry for book purposes until the end of [redacted] tax year when it was written-off as a part of the note balance in a claimed bad debt deduction. The [redacted] did not accrue or pay any interest expenses on the promissory note for book or tax purposes.

The [redacted] transferred the funds it received from [redacted] to the [redacted]. [redacted] was a Florida Limited Partnership which was formed on [redacted] Article [redacted], Section [redacted] of the Limited Partnership Agreement for [redacted] indicated that the partnership was formed "[redacted]" real property[8]

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[6] The [redacted] had no assets or sources of revenue.

[7] Section [redacted] of the Operating Agreement provides that no members shall be liable for the liabilities of the [redacted]

[8] [redacted]

located in [redacted], Florida. The [redacted] signed a "Contract for Purchase and Sale of Property" for this real property. Before the contract would become effective and bind the parties, the [redacted] had to pre-sale at least [redacted] condominium units which were to be built on the real property.

The partners of [redacted] were the [redacted] (a general partner) and [redacted] (a limited partner). Article [redacted] Section [redacted] of the Limited Partnership Agreement provided that the initial capital of [redacted] was specified in Exhibit [redacted][9] The [redacted] which was a general partner of [redacted] had a [redacted]% interest in the partnership in exchange for a capital contribution in the amount of $[redacted]. [redacted], a limited partner, had a [redacted]% interest in the limited partnership in exchange for a capital contribution in the amount of $[redacted].

The financial statements of [redacted] indicate that the partners' capital accounts were in the amounts of $[redacted] and $[redacted], for the tax years ending [redacted] and [redacted], respectively. The statements do not provide a specific breakdown of each partner's capital account.

For the taxable years ending [redacted] and [redacted], [redacted] filed Forms 1065, U.S. Partnership Return of Income, with the Internal Revenue Service. The principal business activity of [redacted] that was listed on the forms was real estate development. Schedule M-2 of the initial return for [redacted] for the taxable year [redacted] indicated that there was capital contributed to [redacted] during the taxable year in the amount of $[redacted]. The Schedule K-1 for the [redacted] indicated a capital account with a beginning and ending balance of [redacted] during the [redacted] tax year. The Schedule K-1 for [redacted] indicated that he made a contribution of capital during the [redacted] tax year in the amount of $[redacted].

On Schedule M-2 of the Form 1065 filed by [redacted] for the taxable year ending [redacted], [redacted] reported a beginning balance of $[redacted] at the beginning of the year, as well as a net loss per its books in the amount of $[redacted]

[redacted]

[9] Article [redacted], Section [redacted] of the Limited Partnership Agreement provided that partner's percentage of interests in [redacted] did not have any relationship to their respective capital contributions to [redacted].

during the tax year. Although the partners' percentage of profit and loss sharing listed on the Schedules K-1 corresponded to the partners' ownership of [redacted] as reflected in the Limited Partnership Agreement, the losses of [redacted] were not allocated in this percentage. The limited partner received a disproportionate amount of the partnership losses.[10] The [redacted] Schedule K-1 for the [redacted] indicated that the [redacted] had a capital account at the beginning of the year with a [redacted] balance and an ending balance of ($[redacted]) as a result of a loss during the tax year. The [redacted] Schedule K-1 for [redacted] indicated that he had a capital account with a balance in the amount of $[redacted] at the beginning of the year. The balance of the capital account of [redacted] was reduced by losses in the amount of $[redacted] resulting in a capital account with a balance of $[redacted] at the end of the year.

[redacted] signed a promissory note to the [redacted] in the amount of "$[redacted], or so much thereof as may be advanced and outstanding pursuant to any advances made by the Lender [the [redacted] to the Partnership [[redacted] according to the grid annexed hereto." The note was dated [redacted]. Between [redacted] and [redacted], the [redacted] transferred funds to [redacted] in the amount of $[redacted] as indicated on the annexed grid attached to the promissory note.

The promissory note was a demand promissory note with a stated interest rate corresponding to the applicable Federal rate. The promissory note had no fixed maturity date and no demand was made on the note. The promissory note was not secured by any assets of [redacted]. The [redacted] did not require the individual partners of [redacted] to personally guaranty the promissory note and no guaranty was given by the partners of [redacted].[11] There is no evidence that the [redacted]

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[10] The method of allocating the loss was clearly contrary to the Limited Partnership Agreement. Article [redacted], Section [redacted] of the Limited Partnership Agreement provided that the profits, losses, deductions and credits of [redacted] were to be allocated in accordance with each partner's respective percentage interest.

[11] Article [redacted] Section [redacted] of the Limited Partnership Agreement provided that a general partner would not be liable for the liabilities of [redacted]. Article [redacted], Section [redacted] of the Limited Partnership Agreement provided that limited partners would not be liable for the liabilities of [redacted] but could elect to be personally liable for any debt incurred by [redacted].

established a repayment schedule for interest and principal and no such repayment was made by [redacted] [redacted] did not accrue or pay any interest expenses on the promissory note for book or tax purposes.

The transferred funds from the [redacted] were used by [redacted] to pay for its operating expenses including professional fees for site plans, construction drawings, environmental assessments, surveying, marketing studies, and for expenses of the sales staff. These expenses were incurred in connection with the marketing of a real estate project in Florida known as the [redacted] ("the [redacted]").[12]

The [redacted] was an [redacted] condominium project. The [redacted] was [redacted], Florida in that it intended to provide [redacted] to each condo unit rather than an entrance or entry fee program. The [redacted] community would have consisted of [redacted] condominiums ranging from one to three bedrooms, a [redacted] square foot clubhouse, and an [redacted] unit assisted living facility. The [redacted] intended to offer its residents services including, but not limited to, dining, transportation, activities, and security. The amenities to be offered to the residents would have been comparable to other [redacted] communities in [redacted], Florida.

The [redacted] was to be built on [redacted] acres of property in [redacted], Florida for which the [redacted] had signed a "Contract for Purchase and Sale of Property." The contract to purchase the land expired on [redacted].[13] Construction of the [redacted] condominium units was to start in the [redacted]. [redacted] obtained conditional financing from [redacted], an Ohio corporation. As a condition in making the loans, [redacted] required that [redacted] had to sell [redacted] condominium units in [redacted]. [redacted] intended to obtain a revolving construction loan to fund the condominium units and clubhouse and a construction term loan to fund the assisted living facility. The funding was to be provided in phases with each phase consisting of the construction of [redacted] condominium units. [redacted] also solicited additional partners to provide equity for its operation by offering a [redacted]% [redacted] in the

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[12] The [redacted] indicated that "funding to date has been provided by [redacted]."

[13] The [redacted] failed to purchase the property.

[redacted]. No individuals accepted this solicitation. [redacted] also failed to sell [redacted] condominium units in [redacted] by [redacted]. Therefore, [redacted] did not loan any funds to [redacted]. Due to a lack of funds, the construction of the [redacted] failed.[14]

The assets of [redacted] were liquidated and generated the amount of $[redacted]. Upon the liquidation of the assets, [redacted] applied the amount of $[redacted] to its promissory note with the [redacted]. [redacted] reported the remaining balance of the note as income from forgiveness of debt. The [redacted] applied the amount of $[redacted] to its promissory note with [redacted]. The [redacted] reported the remaining balance of the note as income from forgiveness of debt. The [redacted] also claimed an ordinary loss from bad debt in the amount of $[redacted] from the note with [redacted]. On its tax return for the tax year ending [redacted], [redacted] claimed an ordinary loss from a bad debt in the amount of $[redacted] from the note with the [redacted].

ANALYSIS

I. MEMBERS OF THE [redacted]

Under the [redacted] Limited Liability Company act, a member's interest in a limited liability company ("LLC") consists of economic and non-economic interests. One interest is a member's capital contribution, which a member may withdraw under certain conditions. [redacted]. A member also generally has the right to receive profits. [redacted].[15] A member's interest also usually grants him

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[14] Despite [redacted]'s failure to obtain financing for the [redacted], as well as its failure to purchase the real property for the project, after [redacted] the [redacted] transferred funds in the amount of $[redacted] to [redacted] in accordance with the purported promissory note dated [redacted].

[15] [redacted] which controls division of profits, envisions withdrawal of capital contribution without dissociation: "[redacted]." This quoted material clearly contemplates a situation where a member has withdrawn some (or even all) of his capital contribution but has not dissociated as a member.

the ability to participate in management. [redacted]. Overall, a member's interest is transferable, although the management rights of a transferee may be limited. [redacted].

[redacted] requires that the articles of organization of an LLC set forth the total amount of cash and a description and agreed value of property other than cash to be contributed to the LLC. The contributions to capital of a member to the limited liability company may consist of cash or other property, promissory notes or services rendered or to be rendered. [redacted]. [redacted] law does not specifically require capital contributions in order to be a member of an LLC. When there is a change in the amount or the character of the contributions to capital, [redacted] requires an amendment to an LLC's articles of organization when the amount or character of contributions changes.

While the [redacted] statutory provisions provide some guidance regarding a member's interest, there is little case law regarding a member's interest in an LLC.[16] In addition to the above statutory provisions, the courts of [redacted] focus on an LLC's operating agreement and articles of organization.

Section [redacted] of the Articles of Organization of the [redacted] provided that the total amount of cash contributed to the LLC was to be $[redacted]. There is no other description in the Articles of Organization of other property that was to be contributed to the LLC. Section [redacted] of the Articles of Organization entitled "[redacted]" provided that "[redacted]."

Section [redacted] of the Operating Agreement of the [redacted] defined "member" as any person who has signed the Operating Agreement as a member. The Operating Agreement was signed by [redacted], [redacted], [redacted], [redacted], [redacted] and [redacted] as "members." Section [redacted] of the Operating Agreement provided that

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[16] See [redacted]. This case was the [redacted]'s first opportunity to interpret the [redacted] LLC act.

the [redacted] would consist of [redacted] membership units, the units were divided among the members as follows:

Member	Units
[redacted]	[redacted]

Section [redacted] of the Operating Agreement provided that the members of the [redacted] would make a total cash contribution of $[redacted]. Specially, each member was to contribute the following amount as set forth in Exhibit [redacted] of the Operating Agreement:

Member	Contribution
[redacted]	$[redacted]

The representative of [redacted] now claims the individuals who signed the Operating Agreement were not members of the [redacted] because they never contributed the capital as required in the Operating Agreement. The shareholders of [redacted] made cash advances to the [redacted] at the time of its formation in excess of these amounts through their corporation [redacted] as well as made subsequent transfers through [redacted] to the [redacted] It is not known whether any services or other property were contributed to the [redacted] by its members.

The individuals who signed the Operating Agreement also continued to conduct business and manage the business affairs of the [redacted] as if they were members including receiving funds from [redacted] in accordance with a purported promissory note and transferring funds to [redacted] in accordance with a purported promissory note. The tax returns filed by the [redacted] also included Schedules K-1 for the individuals who signed the operating agreement. Furthermore, no amendment to the Articles of Organization of the [redacted] was filed with the Secretary of State of [redacted] to change the amount or character of the contributions required in the articles of organization.

Under Section [redacted] of the Operating Agreement, any member of the [redacted] could have been expelled from the LLC if the member committed a breach of a material provision of the Operating Agreement.[17] None of the individuals who signed the Operating Agreement was expelled from the LLC. Nor was any legal action pursued to compel members to make contributions in conformity with the Operating Agreement. Consequently, the individuals who signed the Operating Agreement were members of the [redacted].

II. FUNDS TRANSFERRED BY [redacted]

There are significant tax advantages to classifying a transfer of funds to a pass-through entity as "debt" rather than "equity." Most pertinent to this case, an investment classified as "debt" may give rise to a "bad debt" ordinary loss, while worthless capital contributions would only be treated as a capital loss.

Determining whether advances made by a corporation are bona fide loans depends upon whether, at the time the advances are made, (1) there was a genuine intention to create a debt, (2) there was a reasonable expectation of repayment, (3) the intention to create a debt comported with the economic reality of creating a debtor-creditor relationship, and (4) an unrelated lender would have advanced money to the transferee in the same amount and on the same terms. Litton Business Systems v. Commissioner, 61 T.C. 367, 377-381 (1973), acq., 1974-2 C.B. 3.

A. [redacted] HAD NO INTENTION TO CREATE A DEBT

In determining whether the transactions constituted bona fide loans, the intent of the parties is important. Donisi v. Commissioner, 405 F.2d 481, 483 (6th Cir. 1968). However, declarations of the parties that they intend a transaction to constitute a loan "are insufficient if [the transaction] fails to meet more reliable indicia of debt which indicate the intrinsic economic nature of the transaction." Berthhold v. Commissioner, 404 F.2d 119, 122 (6th Cir. 1968).

The courts have identified and used numerous factors as aids in deciding the intent question, including: (1) the extent to which the related borrower controls the entity; (2) the earnings and dividend history of the corporation; (3) the magnitude of the advances; (4) whether a ceiling exists to limit the amount the

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[17] Under the Operating Agreement, the member had [redacted] days from date of notice to correct such a breach.

corporation advanced; (5) whether or not security is given for the advance; (6) whether there is a fixed maturity date; (7) whether the corporation undertakes to force repayment; (8) whether the borrower is in a position to pay; (9) whether the related borrower attempts to repay; (10) whether interest is charged by the corporation; (11) whether a certificate of indebtedness is given to the borrowing entity; (12) whether the terms of an agreement between the corporation and the related borrower establish an absolute and unconditional duty to repay; (13) whether the advances are proportionate to the related borrower's stock ownership; (14) the source of payments; (15) thin or adequate capitalization; (16) the ability of the corporation to obtain loans from outside sources; (17) the uses to which the advances were put; (18) the failure of the debtor to repay; (19) the risk involved in making the advance; and (20) the payment of interest only out of "dividend" money.[18] In your case, the great weight of the evidence on virtually all of these factors points away from intent to create a debt.

1. Although [redacted] did not own units of the [redacted] of its shareholders did. [redacted], [redacted], [redacted] and [redacted] collectively owned a majority of [redacted], with each individual owning [redacted]%, [redacted]%, [redacted]%, and [redacted]%, respectively. [redacted], [redacted], [redacted] and [redacted] also owned a majority of the membership units of the [redacted]. Each individual owned [redacted] units of the [redacted] of the [redacted] available units. Thus, an element of common control was present, negating any possible inference that [redacted] acted at arm's length to make genuine loans.

2. [redacted] is a profitable corporation which has only declared a single dividend in its corporate existence. In [redacted], a dividend was declared to fund [redacted]'s purchase of real property from its shareholders. The [redacted] never made a profit and could not make a profit unless the [redacted] was

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[18] See, e.g., Alterman Foods, Inc. v. United States, 505 F.2d 873 (5th Cir. 1974), aff'g 73-2 USTC ¶ 9792 (N.D. Ga. 1973); Livernois Trust v. Commissioner, 433 F.2d 879 (6th Cir. 1970), aff'g T.C. Memo. 1969-111; Estate of Chism v. Commissioner, 322 F.2d 956 (9th Cir. 1963), aff'g T.C. Memo. 1962-6; Oyster Shell Products Corp. Inc. v. Commissioner, 313 F.2d 449 (2nd Cir. 1963), aff'g T.C. Memo. 1961-323; Kaplan v. Commissioner, 43 T.C. 580 (1965), acq., 1978-2 C.B. 2, nonacq., 1978-2 C.B. 3; Hambuechen v. Commissioner, 43 T.C. 90 (1964); Roschuni v. Commissioner, 29 T.C. 1193 (1958), acq., 1958-2 C.B. 7, aff'd per curiam, 271 F.2d 267 (5th Cir. 1959), cert. denied, 362 U.S. 988 (1960); Shea v. United States, 83-1 USTC ¶ 9115 (N.D. Ala. 1982).

successful. With ready cash reserves, the shareholders of [redacted] could, and did, use [redacted] to finance its shareholders' investment in the [redacted] without formally declaring dividends.

3. and 4. Over time, the shareholders of [redacted] caused [redacted] to transfer $[redacted] to the [redacted]. All indications are that the only ceiling on the amount which [redacted] would give to the [redacted] was [redacted]'s current income. The [redacted] made no payments of interest or principal to reduce the amount "borrowed." Despite the continued lack of repayment, the shareholders of [redacted] caused [redacted] to continually transfer funds to the [redacted]. Furthermore, after the failure of [redacted], the only potential source of revenue for [redacted] transferred funds in the amount of $[redacted] to [redacted].

5. [redacted] did not demand personal guaranties from the members of the [redacted] and no guaranties were made. [redacted] did not require the [redacted] to provide any security for the transfer of funds and [redacted] received no security for the transfers. This laissez-faire approach was in marked contrast to the usual way loans are made and secured in the banking business.

6. The promissory note that the [redacted] executed was a demand promissory note. However, the note had no fixed maturity date. There was no schedule for repayment of interest or principal on the promissory note. Not surprisingly, there was no repayment.

7. The shareholders of [redacted] never caused [redacted] to undertake procedures to force repayment of principal or interest on the promissory note signed by the [redacted]. No demand for payment was ever made by [redacted].

8. The [redacted] was never in a position to repay [redacted] any amount. The [redacted] had no assets or sources of revenue. It established no credit elsewhere. The only possibility that the [redacted] had for generating income was dependent on its investment in the [redacted]. Even after the failure of [redacted] the shareholders of [redacted] caused [redacted] to continue to transfer funds to [redacted].

9. The [redacted] never established a fund to pay off the loan interest and principal, or had a plan to do so. Likewise, there is no indication that the [redacted] ever attempted to repay the amounts received.

10. Although the promissory note stated an interest rate corresponding to the applicable Federal rate, this provision was mere surplusage. No interest was ever charged by [redacted] and the [redacted] never paid any interest to [redacted]. No interest was accrued for book or tax purposes until the failure of the [redacted] which was concurrent with the write off of the "loan principal."

11. and 12. On its face, the promissory note seemed genuine. However, the financial condition of the [redacted] the inside knowledge of [redacted] as to the financial condition of the [redacted] and the lack of security all combine to point to an obvious conclusion: There was no absolute and unconditional duty on the part of the [redacted] to repay [redacted].

13. The advances [redacted] made to the [redacted] were not proportionate to its ownership in the [redacted]. [redacted] did not own any membership units of the [redacted].

14. With its cash reserves from earnings, [redacted] was able to, and did, transfer funds to the [redacted].

15. The [redacted] was initially thinly capitalized by its members with stated contributions in the amount of only $[redacted]. After transfers from [redacted], the [redacted] was capitalized with a debt to equity ratio of [redacted] to [redacted].

16. The [redacted] never attempted to borrow any funds from a non-related third party. Because of its financial situation, it is doubtful that a non-related third party would have loaned money to the [redacted] without some guaranty or personal liability of the members.

17. The advances received from [redacted] were used by the [redacted] to invest in [redacted]. [redacted] used the transferred funds to pay for its operating expenses including professional fees for site plans, construction drawings, environmental assessments, surveying, marketing studies and for expenses of the sales staff.

18. The lack of intent of the parties to treat the transfers as bona fide loans is also manifested by the lack of repayment. The [redacted] failed to repay any interest or principal of the amounts that were transferred by [redacted].

19. There was great risk to [redacted] in making the advances to the [redacted] [redacted] had inside knowledge of the financial condition of the [redacted]. The [redacted] was thinly capitalized, lacked any source of income and had no assets. In spite of the financial predicament of the [redacted]

[redacted] the shareholders of [redacted] caused [redacted] to transfer funds to the [redacted].

20. [redacted] only formally declared dividends and paid them to the shareholders in [redacted] in connection with [redacted]'s purchase of real property from its shareholders. There were no payments of interest out of dividends. In fact, there was no repayment of any interest out of any financial resources of the [redacted] except upon failure of the [redacted] s project.

B. [redacted] DID NOT HAVE A REASONABLE EXPECTATION OF REPAYMENT

Initially, the [redacted] was thinly capitalized with only $[redacted]. Since it began operations, the [redacted] was receiving funds from [redacted] through the authorization of the shareholders of [redacted]. In the years of the advances, the [redacted] did not show a profit. The [redacted] had no assets. The [redacted] had no sources of revenue independent from its investment in the [redacted]. There was no ceiling on the amount that the shareholders of [redacted] could have caused [redacted] to transfer to the [redacted]

The [redacted] made no payments of interest or principal to reduce the amounts borrowed. In spite of this, the shareholders of [redacted] caused [redacted] to continue to transfer funds to the [redacted]. Even after the failure of [redacted] the shareholders of [redacted] caused [redacted] to continue to transfer funds to [redacted]. The [redacted] simply was incapable of repaying the transfers because it lacked any sources of revenue. Under these circumstances, it is obvious that [redacted] did not have a reasonable expectation of repayment of the funds. See Laidlaw Transp. v. Commissioner, T.C. Memo 1998-232.

C. THE INTENTION OF [redacted] AND THE [redacted] DID NOT COMPORT WITH THE ECONOMIC REALITY OF CREATING A DEBTOR-CREDITOR RELATIONSHIP

Unlike a traditional debtor-creditor relationship, the shareholders of [redacted] caused [redacted] to transfer funds to an entity incapable of repayment. The [redacted] had no assets or sources of revenue independent from its investment in [redacted] Any potential sources of income were directly connected to the [redacted].

The transfers by [redacted] were made under a purported demand promissory note. The promissory note had no fixed maturity date and no demand was made on the note. The promissory note was not secured by an assets of the [redacted]. The shareholders of [redacted] did not require that [redacted] have the individual members of the [redacted] personally guaranty the promissory note. No guaranty was given by the members of the [redacted] There is no evidence that [redacted] established a repayment schedule for interest and principal and no such repayment was made by the [redacted]. The lack of intent of the parties to treat the transfers as bona fide loans is also manifested by the failure of [redacted] to accrue interest expenses on its books until they decided to write-off the "loan principal."

D. AN UNRELATED LENDER WOULD NOT HAVE ADVANCED MONEY TO THE [redacted] IN THE SAME AMOUNT AND ON THE SAME TERMS AS [redacted]

An unrelated lender would not have transferred funds to the [redacted] on the same terms and conditions that the shareholders of [redacted] caused [redacted] to transfer the funds to the [redacted]. The [redacted] was organized on [redacted] with initial capital contributions in the amount of $[redacted]. The [redacted] had no other assets. The [redacted] signed a promissory note to [redacted] but the shareholders of [redacted] did not require that [redacted] compel the [redacted] to pledge any security for the funds received and the [redacted] did not pledge any security. [redacted] did not demand that the members of the [redacted] personally guaranty the promissory note and members of the [redacted] did not personally guaranty the promissory note. [redacted] failed to have the [redacted] establish a repayment schedule for interest and principal for the funds that the shareholders of [redacted] caused to be transferred to the [redacted]. [redacted] continued to transfer funds to the [redacted] even though the [redacted] never made any repayment of interest or principal on the promissory note. Transfers of funds were even made after the failure of [redacted] the only potential source of income for the [redacted] Based on these facts, an unrelated lender would not have loaned money to the [redacted] on the same generous terms and conditions that the shareholders of [redacted] caused [redacted] to transfer funds to the [redacted][19]

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[19] The attempt of [redacted] to obtain financing from an unrelated lender is a comparable situation. Although the specific terms and conditions of the financing are not known, the unrelated commercial lender would not have loaned money to the limited partnership which had no assets or sources of revenues until a specific number of condominiums were pre-sold. Because the minimum sales requirement was not met, the unrelated commercial lender did not make the loans to [redacted].

III. IN REALITY THE TRANSFERS FROM [redacted] TO THE [redacted] WERE CONSTRUCTIVE DIVIDENDS TO THE COMMON SHAREHOLDERS OF [redacted] AND THE [redacted]

Under I.R.C. §§ 301 and 316, dividends to a shareholder must be included in gross income. Usually, when a corporation makes distributions of property to its shareholders with respect to its stock, out of accumulated or current earnings and profits, it formally declares dividends and pays them to the shareholders. Not all dividends follow that pattern. <u>See</u>, <u>e.g.</u>, <u>Radnay v. Commissioner</u>, T.C. Memo. 1989-237 (holding that a shareholder received a dividend when corporation paid his entertainment expenses), <u>aff'd without opinion</u>, 921 F.2d 285 (11^{th} Cir. 1990); <u>Finney v. Commissioner</u>, T.C. Memo. 1980-23 (holding that corporate payments of officers' personal and living expenses were dividends to the officers). It is well established that distributions by a corporation will be treated as a dividend to the shareholder if the distributions are made for the shareholder's personal benefit. <u>See</u> <u>J.F. Stevenhagen Co. v. Commissioner</u>, T.C. Memo. 1975-198, <u>aff'd</u>, 551 F.2d 106 (6^{th} Cir. 1977).

The Tax Court has even held that the transfer of funds from one corporation to another entity, both wholly owned by the same shareholders, may result in a constructive dividend to the common shareholders where the advance constitutes contribution to capital, not <u>bona</u> <u>fide</u> debt. <u>See</u> <u>Shedd v. Commissioner</u>, T.C. Memo. 2000-292; <u>Davis v. Commissioner</u>, T.C. Memo 1995-283.

The courts apply a two-prong test to determine whether the transfers result in constructive dividends. <u>Sammons v. Commissioner</u>, 472 F.2d 449, 451 (5^{th} Cir. 1972), <u>aff'g in part, rev'g in part</u>, T.C. Memo. 1971-145. Under the first prong, an objective test, the court ascertains whether the shareholder exercised control over the transferred funds. Under the second prong, a subjective test, the court ascertains whether the primary purpose of the transfer was to benefit the common shareholder. <u>See</u>, <u>e.g.</u>, <u>Wilkof v. Commissioner</u>, T.C. Memo. 1978-496, at 1851-38, <u>aff'd per curiam</u>, 636 F.2d 1139 (6^{th} Cir. 1981); <u>McLemore v. Commissioner</u>, T.C. Memo. 1973-59, <u>aff'd</u>, 494 F.2d 1350 (6th Cir. 1974).

Under the corporation to entity fact pattern, the transferred funds are first considered distributed from the transferor corporation to the common shareholder, and the shareholder is then considered to have contributed the funds to the transferee entity's capital. <u>Sammons</u>, at 453. The facts in this case indicate that [redacted] and the shareholders of [redacted] should also be treated in this manner.

[redacted], [redacted], [redacted] and [redacted] held a majority of the stock in [redacted], each owning [redacted]%, [redacted]%, [redacted]%, and [redacted]%, respectively. [redacted], [redacted], [redacted] and [redacted] also owned a majority of the membership units of the [redacted]. Each individual owned [redacted] membership units of the available [redacted] units. The shareholders of [redacted] caused [redacted] to transfer $[redacted] to the [redacted], over which [redacted], [redacted], [redacted] and [redacted] then clearly exercised control.

The advances from [redacted] to the [redacted] were for the daily operating expenses of [redacted] which the [redacted] had invested in. [redacted] had no equity in the [redacted]. [redacted] did not transfer the funds in anticipation of selling products to the [redacted]. [redacted] had no business relationship with the [redacted] other than common shareholders. The facts fail to disclose a business purpose for the transfers.

In addition, [redacted], [redacted], [redacted] and [redacted] were able to use the funds of [redacted] to operate the [redacted] and [redacted] without using their own personal resources. By causing [redacted] to transfer funds to the [redacted], [redacted], [redacted], [redacted] and [redacted] were able to carry on a business with extremely thin capitalization without having their personal funds subordinated to the substantial indebtedness of the transferee LLC. These benefits were direct, not derivative. Consequently, there was no satisfactory primary business purpose for the transfers other than supplying a large amount of risk capital to an entity wholly unrelated in function and operation to the transferor corporation.

This memorandum is subject to post-review by the Office of Chief Counsel, under CCDM (35)3(19)4. We will inform you of any modification of this advice.

If you have any questions, please contact the undersigned at [redacted]

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